

**TESTIMONY OF THE INTERNATIONAL DAIRY FOODS ASSOCIATION
SEPTEMBER 2002 FEDERAL MILK ORDER HEARINGS
DOCKET NOS. AO-14-A70; DA-02-01**

This testimony is submitted on behalf of the International Dairy Foods Association, its constituent groups, and their members. IDFA is a trade association representing processors, manufacturers, marketers, distributors, and suppliers of dairy foods, including milk, cheese, ice cream and frozen desserts. IDFA serves as an umbrella organization for three constituent groups: the Milk Industry Foundation ("MIF"), the National Cheese Institute ("NCI"), and the International Ice Cream Association ("IICA"), which together represent about 85 percent of all dairy product processing in the \$70 billion U.S. dairy foods industry. MIF has over 110 member companies that process and market about 90% of the fluid milk and fluid milk products consumed nationwide; NCI has over 70 member companies that manufacture, process and market more than 85% of the cheese consumed in the U.S.; and IICA has over 80 member companies that manufacture, market and distribute an estimated 85% of the ice cream and ice cream-related products consumed in the United States.

As buyers and processors of milk, the members of IDFA and its constituent organizations have a critical interest in this hearing. Most of the milk bought and handled by IDFA members is purchased under the Federal milk marketing orders promulgated pursuant to the Agricultural Marketing Agreement Act of 1937 (the "AMAA").

I am Dr. Robert D. Yonkers, Chief Economist and Director of Policy Analysis at IDFA. I have held that position since June 1998. I hold a Ph.D. in

Agricultural Economics from Texas A&M University (1989); a Masters degree in Dairy Science from Texas A&M (1981); and a Bachelor of Science degree in Dairy Production from Kansas State University (1979). I have been a member of the American Agricultural Economics Association since 1984.

Prior to taking my current position at IDFA, I was a tenured faculty member in the Department of Agricultural Economics and Rural Sociology at The Pennsylvania State University, where I was employed for nine years. At Penn State, I conducted research on the impacts of changing marketing conditions, alternative public policies, and emerging technologies on the dairy industry. In addition, I had statewide responsibilities to develop and deliver extension materials and programs on topics related to dairy marketing and policy. I have written and spoken extensively on economic issues related to the dairy industry, and have prepared and delivered expert witness testimony to state legislatures and to Congress.

This hearing was called to consider a number of proposals that would amend certain provisions of the Northeast order. My testimony will address one of those proposals, No. 7, which would establish so-called marketwide service payments.

IDFA and its constitute groups strenuously oppose this proposal and urge USDA to reject it. IDFA's opposition is based upon the following reasons:

- 1. Over the last forty years, USDA has on a number of occasions denied proposals to amend federal orders to provide for marketwide service payments. USDA did so most recently in 1999, with respect to a proposal advanced for the Northeast order that is very similar to the**

one at issue in these hearings. There have been no changes in dairy industry market conditions that would justify a different result now.

2. In their March 8, 2002 letter to USDA requesting this hearing, the proponents of Proposal No. 7 stated that marketwide service payments are needed in order to “provide reimbursement” for their “balancing activities.” The proponents have confirmed in their testimony that this is the sole justification they advance for their proposal. But even if balancing presented an issue that needs to be addressed through the federal order program, it has already been addressed. Based upon the testimony and proposals of the cooperatives themselves, USDA set a Class IV make allowance that is high enough to allow Class IV plants to cover 100% of their costs, *including all costs of balancing*. Indeed, when USDA set the make allowances for these products, it explicitly stated that it was setting a make allowance high enough to pay the costs incurred by balancing plants. *Proposal No. 7 thus constitutes an effort to be paid twice for the same thing.*

3. Even if (contrary to fact) there were somehow a need to provide even more funds to cover the cost of balancing, these costs are more than amply covered by over order premiums that are already being paid to Class IV handlers in the Northeast order. Whenever a Class IV handler provides milk to a Class I handler in lieu of processing that milk in its own plant, the Class IV handler receives an over order

premium from the Class I handler. Put another way, if, as the proponents claim, they incur costs when their plants run at less than full capacity in order to meet the needs of the Class I market, those costs are already more than covered by the extra money they receive via Class I over order premiums.

4. A principal justification advanced for marketwide service payments is the purported costs of balancing the market due to seasonality in milk production. But the seasonality of milk production has declined precipitously for many years, and continues to do so. Marketwide service payments is a concept whose time came and went decades ago (and even then rested on rickety legs).

5. Proposal No. 7 is hopelessly flawed. Large cooperatives would qualify for payments without performing any marketwide benefits whatsoever. Small handlers would not qualify for payments regardless of the balancing they perform. In these respects, the proposal is a direct violation of AMAA requirements. Moreover, the significant flow of milk into and out of the Northeast order would result in Northeast producers making marketwide service payments when the balancing services were being provided to producers located in other orders. This is the very defect that led USDA to reject marketwide service payments when they were considered for the Southeast orders.

6. Finally, in light of the fact that no rationale exists for marketwide service payments in the first place, there is obviously no emergency that could warrant the omission of a recommended decision. Instead, the proposal should be rejected in its entirety.

I. USDA HAS FREQUENTLY REJECTED PROPOSALS FOR MARKETWIDE SERVICE PAYMENTS OVER THE LAST FORTY YEARS.

I will briefly recount past USDA decisions to reject marketwide service payment proposals, and then apply the reasoning that underlies USDA's past decisions to show why Proposal No. 7 suffers from the same defects as did these previous proposals.

The 1940s through 1985. At the end of the 1940s, four of the 39 federal orders then in existence contained provisions providing for marketwide service payments, but the Boston order provision was declared unlawful by the United States Supreme Court in 1952. Following that court decision, USDA removed similar provisions in the Cincinnati and Dayton-Springfield orders. That left New York as the only order providing for such payments. In the case of New York, marketwide service payments could be earned, but only for services that were clearly laid out in the order provisions, and for which qualifying entities had to submit detailed reports to the Market Administrator in order to receive any payments.

Cooperatives on a number of occasions attempted to persuade USDA to adopt marketwide service payments in other orders, or at least to hold hearings to consider them. But USDA always rejected those proposals.

This history was recounted in detail by Herbert L. Forest, who began working at the Dairy Division in 1935, before the AMAA was even enacted, and served as Director of the Dairy Division of USDA for 30 years, from 1952 through 1982. As Mr. Forest stated:

The Department has always taken a strong position against any proposal that involved deductions from dairy farmers through pool deductions. Until recently, there was always a strong legal basis for this position because of the Stark case, which ruled that deductions from the pool in the Boston Market for marketwide services were illegal. But even more than the legal basis, our position was based on a more basic premise -- and that was that the people who got the benefit of the services should be the ones who should pay for them. I still feel strongly that this is the way it should be. If a chain store operating its own bottling plant wants specific quantities of milk on only 4 or 5 days, then they should pay for that kind of service. The cost of operating its plant is lower than the handler who receives all the milk from its dairy farmers 7 days a week. Likewise, if a dairy farmer wants to be guaranteed a market for all his milk 7 days a week, he can get it through his cooperative. And he should expect to pay for that guarantee. There is no obligation under the orders that requires a cooperative to perform any services for free.

The orders recognize the need for cooperatives to be paid for services performed by setting only a minimum price. The Act provides for co-ops to charge farmers under contract for services performed for them. For the most part, if a service is sought by the buyer, the buyer should pay for it. If the buyer doesn't want the service, the question arises as to who the beneficiary is. If it is for the cooperative members, they should pay for it. It is very difficult to identify services performed by cooperatives for which the beneficiary is not the buyer of their milk or the members of the cooperative. (Sworn Testimony of Herbert L. Forrest, Hearings to Consider Payments Under Seven Southeastern Orders for Marketwide Service Payments, Docket Nos. AO-366-A28 et al., Sept. 8, 1986).

1985 through 1998. After the 1985 Farm Bill amended the AMAA explicitly to authorize payment to handlers for "services of marketwide benefit," a proposal was advanced to add such payments to the seven Southeastern orders then in existence. But after extensive hearings, which lasted for 10 days, involved 42 witnesses and 122 exhibits, and produced 2951 pages of transcript, USDA concluded that "the record evidence does not demonstrate that the proposed marketwide service provisions would effectuate the purposes of the Agricultural Marketing Agreement Act of 1937, as amended." Milk in the Georgia and Certain Other Marketing Areas, Docket Nos. AO-366-A28 et al., Federal Register, Volume 52, Page 15951 (May 1, 1987). That decision brought to an end proposals that had been bandied about to add marketwide service payment provisions in other orders as well. Later, I will discuss in more detail the reason why USDA rejected the Southeastern orders proposal, and the implications of that reasoning for the proposal at issue at these hearings.

1998-2002. The 1996 FAIR Act mandated the consolidation of existing orders into a smaller number of geographically larger orders. This meant that the New York-New Jersey order—the only one in the country that had a marketwide service payment provision—would be consolidated with two orders that did not (the New England and Atlantic orders). The question was thus presented—would the consolidated Northeast order have a marketwide service payment as had the New York-New Jersey order, or exclude such payments as they had been excluded from the two other orders? The quantity of milk pooled on those two orders combined slightly exceeded the quantity pooled on the New York-New Jersey order.

ADCNE, the proponents of the current Proposal No. 7, submitted a proposal to USDA in 1997 to adopt a marketwide service payment provision in the merged Northeast order. As with Proposal No. 7, ADCNE sought a payment of 6 cents per hundredweight (comprised of 2 cents for cooperative service payments and 4 cents for purported balancing services).

USDA rejected that proposal in its proposed rule published in January 1998, finding, among other things, that (1) two of the three orders merged into the Northeast order had no such provisions prior to order reform, and had no evidence of harm or disadvantage arising from the lack of them; and (2) a separate Class IV milk price provides handlers with a market clearing price, and further compensation beyond this is not warranted. Federal Register, Volume 63, Pages 4951 through 4952 (Jan. 30, 1998).

After USDA published this proposed rule rejecting any marketwide service payment provisions, ADCNE modified its proposal, this time proposing a 6 cent per hundredweight payment solely for purported balancing services. USDA again rejected this proposal, again noting among other things that (1) two of the three orders merged into the Northeast order had no such provisions prior to order reform, and had no evidence of harm or disadvantage arising from the lack of them; and (2) a separate Class IV milk price provides handlers with a market clearing price, and further compensation beyond this is not warranted. Federal Register, Volume 64, Pages 16146 through 16148 (April 2, 1999).

All of this history makes perfectly clear that USDA rejected marketwide service payments for the Northeast, as recently as 1999, with respect to a very

similar proposal, submitted by the very same group that has put forth Proposal No.

7. IDFA submits that these proponents carry a very heavy burden of proving that marketwide service payments in the Northeast, which previously had made no sense to USDA, are suddenly somehow a good idea.

In fact, the purported justifications for such payments have only grown weaker.

II. BALANCING COSTS ARE ALREADY PAID FOR THROUGH THE MAKE ALLOWANCE.

The costs of balancing are already fully paid for through the make allowance on Class IV products. USDA explicitly set the make allowance for these products at a level sufficient to enable Class IV processors to cover their balancing costs. *Proposal No. 7 thus constitutes an effort to be paid twice for the same thing.*

In making this point, I am simply elaborating upon the conclusion that has already been reached by USDA, not once, but twice. When USDA in its 1998 proposed rule rejected ADCNE's proposal for marketwide service payments, it made the following statement, which I wholeheartedly endorse:

[I]n addition to expressed opposition to compensate handlers for balancing the market, an appropriate class price has been provided for market clearing purposes--the Class III--A price. It is a price that is applicable in all current Northeast orders, and is continued in this proposed rule as the Class IV price. While these two class prices are not the same (as explained in the BFP section of this decision), they are conceptually similar in that handlers have been provided with a market clearing price and *further compensation beyond this is not warranted.* Federal Register, Volume 63, Pages 4951 through 4952 (Jan. 30, 1998).

As I have noted previously, ADCNE responded to this proposed rule with an amended marketwide service payment proposal, which USDA also rejected in the 1999 final rule. In so doing, USDA again made a similar observation:

The proposed rule also indicated that balancing payments should not be adopted because an appropriate class price has been provided for market clearing purposes -- the Class IIIA price. It is a price that is applicable in all current northeast orders, and is continued in this decision as the Class IV price. While these two class prices are not the same, (as explained in the BFP section of this decision) they are conceptually similar in that handlers have been provided with a market clearing price and *further compensation beyond this does not appear to be warranted*. Federal Register, Volume 64, Page 16148 (April 3, 1999).

In both of these decisions, USDA correctly concluded that Class IV (Class III-A prior to order reform) provides the mechanism under federal order regulation to clear the market, and in so doing, covers balancing costs.

Moreover, and of great significance, USDA subsequently, and explicitly, set the make allowance at a level sufficiently high to cover all balancing costs incurred by Class IV butter and powder plants.

Under the order system in place since January 1, 2000, the minimum Class IV milk price for butter and for nonfat dry milk equals the actual finished product price (as determined by monthly survey) minus the make allowance. Thus, the make allowance equals the actual finished product price minus the minimum milk price established by regulation.

The make allowance is set at a level designed to cover all costs of owning and operating a plant that processes milk into the two Class IV products. This includes both fixed costs (such as the cost of building the plant, which is accounted for

through a charge for depreciation), and variable costs (electricity, labor, packaging, etc.), as well as marketing expenses and a return on investment.

The make allowances currently in place were set as a result of the Class III and IV formula hearings held in May 2000. Although IDFA testified extensively at those hearings regarding the proper make allowance for Class III products (cheese), it does not represent butter and nonfat dry milk producers and accordingly did not itself address the proper make allowance for those products. Rather, the proper make allowance for Class IV products was established through the proposals and testimony of the cooperative processors, who produce about 70% of these products, and their associations.

The cooperatives presented data from two surveys to determine the proper make allowance—one survey that had been conducted by USDA's Rural Business Cooperative Service and one by the California Department of Food and Agriculture. The CDFA data came directly from the audits that trained CDFA auditors routinely perform of California butter powder plants, and which CDFA then publishes.

Based upon this data, USDA in its December 2000 tentative final decision adopted an 11.5 cent make allowance for butter, and a 14.0 cent make allowance for nonfat dry milk. These make allowances came into effect January 1, 2001, and are the make allowances now in place. (USDA's subsequent recommended decision, which when finalized will implement make allowances on a permanent basis, proposes to leave unchanged the make allowance for both butter and nonfat dry milk that were established in the tentative final decision. Federal Register, Volume 66, Pages 54064 through 54096 (Oct. 25, 2001).)

In setting these make allowances for butter and for nonfat dry milk, USDA explicitly stated that it was establishing make allowances at a level high enough to cover all the costs incurred by a balancing plant—*the very costs that ADCNE seeks to have paid—for a second time— through Proposal No. 7.* USDA stated as follows:

Make Allowance (Butter). The make allowance factor in the Class IV butterfat formula should be derived from a combination of the manufacturing costs determined by the California Department of Food and Agriculture (CDFA) and by USDA's Rural Business Cooperative Service (RBCS), as they were in the final decision. The CDFAs cost data is divided into two groups representing high cost and low cost butter plants, with the 4 plants in the high cost group manufacturing, on average, about the same average number of pounds of butter as the 7 plants in the RBCS study. *Use of the data for the California high-cost group of butter plants is more appropriate than use of the weighted average cost for all of the CDFAs plants because it is more likely that the high-cost plants, like the plants in the RBCS survey, serve a predominately balancing function.*

When the RBCS data is adjusted to reflect the same packaging cost, general and administrative costs, and return on investment as the CDFAs data for the high cost group, and a marketing allowance of \$0.0015 is added to both sets of data, the weighted average of the two data sets is \$0.115. *This butter manufacturing allowance is very close to the current allowance of \$0.114, and should continue to provide a representative level of the costs of making butter in plants that serve a balancing function.* Federal Register, Volume 65, Page 76842 (Dec. 7, 2000).

Thus, USDA intentionally set a make allowance for butter that is high enough to cover balancing costs. And USDA also did the same with respect to nonfat dry milk:

On the basis of the data and testimony included in the hearing record, the manufacturing cost level that appears to be most appropriate for use in the pricing formula for nonfat solids is \$0.14. This value is calculated by using a weighted average of the RBCS survey and the two less-cost California groups of plants, adding the California General and Administrative costs and Return on Investment expenses for those two groups to the RBCS numbers, and a \$0.0015 marketing allowance to both sets of data. The basis for using the two lower-cost

groups of California plants are that the mid-cost group is of a similar average size as the group included in the RBCS survey, and that the lowest-cost California group has a very similar total cost to the mid-cost group. *These three groups of plants (the RBCS plants and the two California groups) are similar enough in size and cost to consider as fairly representative, and should encompass those plants that perform a market balancing function.* Federal Register, Volume 65, Page 76843 (Dec. 7, 2000).

I will have to leave it to the proponents to try to explain why they are entitled to marketwide service payments to cover the costs of balancing, when USDA in year 2000 and year 2001 purposely set the make allowances high enough so that they would fully recover those costs through the make allowances.

It is important to note that the cooperatives were given a full opportunity to respond to USDA's statements in the tentative final decision that it had purposely set the make allowance so as to cover the costs of those plants that perform a market balancing function. The tentative final decision from which I have just quoted was issued in December 7, 2000, in order to meet the congressional mandate that the new make allowances go into effect by January 1, 2001. But parties were given the opportunity to submit comments on the tentative final decision and to suggest changes that should be made.

As best as IDFA can determine, not a single cooperative or farmer organization challenged USDA's statement that the butter and non fat dry milk make allowances had been set to reflect the costs incurred by plants that provide balancing functions. To the contrary, the National Milk Producers Federation submitted comments on January 31, 2001 stating that it "supports the decision with one exception," and that exception did not relate to make allowances. ADCNE itself submitted comments on February 9, 2001, and under the heading "ADCNE

Comments Upon the Make Allowances Adopted for Class III and IV, stated as follows:

“In determining the appropriate make allowances for Class III and Class IV prices, ADCNE suggested that the Department should use all credible, reliable information available to it, and we believe the Department did so and commend the decision in that regard.”

ADCNE’s written submission went on to comment on two aspects of the Class III (cheese) make allowance, but said nothing more on the Class IV (butter and nonfat dry milk) make allowance.

The absence of criticism is reflected in the recommended decision that USDA published on October 25, 2001, which suggested certain changes in the formulas adopted in the tentative final decision, but no changes to the Class IV make allowances. In that recommended decision, USDA stated: “No comments were filed that specifically addresses the adopted make allowance for use in the nonfat solids price.” Federal Register, Volume 66, Page 54078. And USDA’s discussion in the recommended decision of the butter make allowance does not reflect that any comments were filed as to that make allowance either.

To the contrary, USDA in the recommended decision repeated virtually verbatim the conclusions it had reached in the tentative final decision regarding the fact that the make allowances had been set so as to encompass the costs of balancing. It did so with respect to the butter make allowance:

“Use of the data for the CDFFA high-cost group of butter plants is more appropriate than use of the weighted average cost for all of the California plants because it is more likely that the high-cost plants, like the plants in the RBCS survey, serve a predominately balancing function....This butter manufacturing allowance is very close to the current allowance of \$0.114, and should continue to provide a representative level of the costs of making butter in plants that serve a

balancing function.” Federal Register, Volume 66, Page 54077 (Oct. 25, 2001).

And USDA did so with respect to non fat dry milk as well: “These three groups of plants (the RBCS plants and the two California groups) are similar enough in size and cost to consider as fairly representative, and should encompass those plants that perform a market balancing function.” Federal Register, Volume 66, Page 54078 (Oct. 25, 2001).

Further confirmation that the make allowance already covers balancing costs can be derived from the study by Dr. Ling that the proponents rely upon in their proposal—“Cost of Balancing Milk Supplies: Northeast Regional Market,” published by the RBCS (Report 188). Although I do not, for reasons I will discuss later, agree with several aspects of that study, the key point here is that Dr. Ling concludes that, assuming operating reserves are 10% and seasonal reserves are as he calculated, all of the balancing needs of the Northeast order can be provided by three butter powder plants which can each process three million pounds of milk per day at full capacity, and which on average *operate at 67% of plant capacity on an annual basis*. Dr. Ling then concludes that, assuming operating reserves are 20% and seasonal reserves are as he calculated, all of the balancing needs of the Northeast order can be provided by four butter powder plants which can each process three million pounds of milk per day at full capacity, and which on average *operate at 75% of plant capacity on an annual basis*.

But the plants whose costs were utilized for purposes of setting make allowances only operate on an annual basis at 47.9% of plant capacity. That was the testimony at the May 2000 milk order hearings of Land O’ Lakes witness Dennis

Schad, who testified that “the RBCS survey of seven butter powder plants places the average utilization of those plants at 47.9.” (Hearing Transcript, p. 1212). USDA picked up on this fact in its December 7, 2000 tentative final decision, noting that “the capacity utilization estimates [are] less than 50 percent for the plants in the RBCS survey.” Federal Register, Volume 65, Page 76843. USDA made the exact same observation in the October 25, 2001 recommended decision. Federal Register, Volume 66, Page 54078 (“the capacity utilization estimates [are] less than 50 percent for the plants in the RBCS survey”).

All else being equal, a plant that operates at a higher percent of capacity will have lower per unit of production costs than a plant operating at a lower percent of capacity. Thus, given that USDA set the make allowance so that a butter powder plant operating at 47.9% of capacity could cover all of its fixed and variable costs (including a return on investment), it necessarily follows that a plant operating at 67%, or 75%, of capacity will do so.

We can use real numbers to demonstrate this point. Dr. Ling calculates that each of the plants needed for balancing will, if operated at 100% of capacity, receive 3 million pounds of milk a day, or 1.08 billion pounds of milk a year assuming the plant operates 360 days per year, which is 10.8 million hundredweights. This would result in the production of 48.384 million pounds of butter, and 87.804 million pounds of non fat dry milk if the plant operates at full capacity, according to the amount of butter and non fat dry milk that can be produced from a hundredweight of milk as stated in footnote 2 of Tables 3 and 5 of Dr. Ling’s study. If, as Dr. Ling assumes, each of the plants will only operate at 67% of capacity in order to provide

necessary balancing, they will then each produce 32.417 million pounds of butter, and 58.829 million pounds of non fat dry milk.

The question, which was not addressed by Dr. Ling, is—have the make allowances for butter and non fat dry milk been set at a level that will cover fixed and variable cost, assuming this level of production? The answer is yes.

Let's start with fixed costs. The make allowances for both butter and non fat dry milk include at least two elements to cover the capital costs identified by Ling—depreciation and return on investment (i.e., the cost of capital). Per pound of butter, the make allowance includes 1.181 cents per pound for depreciation and 0.73 cents per pound for return on investment, based on the depreciation figure in the RBCS cost of production study presented at the May 2000 hearing, and the California Department of Food and Agriculture data on return on investment that was adopted by USDA. The two combined equal 1.911 cents per pound of butter. Per pound of non fat dry milk, the make allowance includes 1.812 cents per pound for depreciation and 1.74 cents per pound for return on investment, based on the depreciation figure in the RBCS cost of production study presented at the May 2000 hearing, and the California Department of Food and Agriculture data on return on investment that was adopted by USDA. The two combined equal 3.552 cents per pound of non fat dry milk.

When one applies this to the pounds of butter and non fat dry milk produced at the plant operating at 67% capacity, one can easily calculate that the plant will receive through the make allowance \$2,709,100.00 to cover its fixed costs, consisting of \$619,500.00 for butter (1.911 cents per pound times 32.417 million pounds of

~~100%~~, and \$2,089,600.00 for non fat dry milk butter (3.552 cents per pound times 58.829 million pounds of non fat dry milk). This \$2.7 million is more than enough to cover the \$2.52 million of capital costs identified by Dr. Ling for the entire facility. Dr. Ling also identifies additional fixed costs for insurance, taxes, licenses and administration, but each of these costs was either a line item in the RBCS survey data introduced at the May 2000 Class III and IV formula hearings at which the make allowances were set, or were explicitly added on top of the RBCS survey data results by USDA in its decisions setting the make allowances.

That covers fixed costs. As for variable costs, Dr. Ling himself said in his study, and repeated in his testimony at this hearing, that every 1% increase in capacity utilization results in a 0.1 cent decrease in variable costs per pound of product manufactured. Obviously, since Dr. Ling's plants operate at 67% of capacity and the variable costs covered in the butter and powder make allowance were based using a plant operating at 48% capacity, Dr. Ling's plants will receive more than enough money through the make allowance to cover their variable costs.

Indeed, Dr. Ling's methodology would suggest that the current make allowance is 1.9 cent per pound higher than it need be to pay for the variable costs incurred in his balancing plants, since they operate at 19 percentage points greater capacity utilization than the plants used to set the make allowance.

I could do the same calculations for Dr. Ling's alternate assumption of balancing plants that provide operating reserves of 20% and therefore operate at 75% of annual capacity. But obviously, that higher capacity utilization will produce

more pounds of butter and non fat dry milk, providing even more money to cover fixed and variable costs.

This is a lot of math, but it is all intended simply to demonstrate that USDA was absolutely correct when it stated in the tentative final decision, and again in the recommended decision, that the make allowances would cover the costs of balancing.

Thus, the make allowances themselves will cover all of the balancing costs that Dr. Ling identifies, and there is no possible justification for imposing marketwide service payments. In this regard, I will note that Dr. Ling's study only purports to calculate the *costs* of balancing, and nowhere addresses whether those costs have already been *paid for* through make allowances.

III. EVEN IF MORE FUNDS WERE SOMEHOW NEEDED TO COVER THE COST OF BALANCING, THOSE FUNDS HAVE BEEN MORE THAN AMPLY PROVIDED THROUGH OVER ORDER PREMIUMS.

Given USDA's decision to set Class IV make allowances at a level that will cover balancing costs, there may be little point in establishing that there are additional ways those costs can be covered without resorting to mandatory marketwide service payments. But the fact is, such a mechanism is already in place, through the existing over order premiums in the Northeast order.

Each month a Class I user pays the Class I minimum price as determined by the Class I mover plus the plant location differential. In many markets, including the Northeast order, cooperatives then add a surcharge to this minimum price. These are the payments that cooperatives receive on every hundredweight of milk that they provide to a Class I handler.

These over order premiums may be contracted between a buyer and a supply cooperative, and can and often do include a schedule of premiums, charges and credits for varying supplies of additional milk or timing of deliveries. The premiums also may be negotiated on an as needed basis, in which case there is often a "give up" charge added to cover the opportunity cost of selling that volume of milk rather than running it through the manufacturing plant. Regardless of the structure, the cooperative is receiving more money than the Federal Order minimum that the buyer was obligated to pay for Class I milk. These premiums are the cooperatives' method of recouping the expenses related to any services provided to the buyer, including supply management or balancing.

USDA-AMS publishes the simple average of these over-order premiums by market city in its annual summaries. In the northeast, the 2000-2001 simple average for Boston, MA; Philadelphia, PA; and Baltimore, MD were, respectively, \$0.75, \$1.66, and \$1.56 per hundredweight. We can estimate the effect these premiums had on net income to all milk suppliers if we multiply the average premiums by the average Class I utilization (45%) in the Northeast order. On an all milk basis the premiums bring additional revenues of \$0.34, \$0.75, and \$0.70 per hundredweight. These receipts are far in excess of the requested six cents per hundredweight marketwide service payment, and are already being provided by the market.

Another way to think of it is to see the Class I over order premiums as the "give up" charge that a cooperative charges a Class I handler for providing milk to the Class I handler rather than processing the milk through the cooperative's own Class IV facility. The \$0.75, \$1.66 and \$1.56 Class I over order premiums received

by cooperatives are more than sufficient to cover the per hundredweight cost the cooperative incurs to provide balancing reserves, even assuming that they are not already being covered by the make allowance (which they are).

Specifically, Dr. Ling's analysis is based upon the assumption that the need to provide balancing requires a Class IV plant to maintain substantial unused capacity in certain months (especially during the fall), so that in those months, milk that would otherwise be available for processing in that plant can be sent to Class I plants to meet Class I needs. Under Dr. Ling's analysis, the Class IV plant will use that extra capacity to process that milk in the spring, when supplies exceed Class I needs.

Dr. Ling's study analyses the cost of this balancing on a month by month basis, and concludes that the cost of balancing reaches a peak of 63 cents per hundredweight in October. (Ling, page 8, Table 5.) Yet the cooperative will receive more than this amount per hundredweight through the \$0.75, \$1.66 and \$1.56 per hundredweight Class I over order premium it will receive.

IV. MARKET TRENDS HAVE GREATLY WEAKENED WHATEVER JUSTIFICATION EVER EXISTED FOR MARKETWIDE SERVICE PAYMENTS.

The proponents assert that marketwide service payments are needed because they are incurring costs associated with the need to dispose of milk during periods it is not needed for Class I purposes. I have in previous sections of my testimony demonstrated the ways in which those costs are already and appropriately being handled without any provision for marketwide service payments. But in this section

of my testimony, I address an antecedent question—whether the disposal of this “reserve” milk is a major issue to begin with.

The amount of reserve milk is largely a function of two very separate issues. The first relates to seasonal variations in both milk supplied to the market and the demand for milk to be used in fluid dairy products. The seasonal variation in Class I use in the Northeast markets has in fact changed little over time. Therefore, the major issue related to seasonal reserves is the change over time in seasonal variation in milk production.

It is extremely revealing to examine trends in the seasonality of milk production in the United States over the past 50-plus years. I have charted USDA data for total U.S. milk production on Chart 1 of my testimony. Each of the colored lines charts seasonality during a three year period, starting with the period 1949 through 1951 (the green line), and continuing, in 10 year intervals, through the period 1999 through 2001 (the red line).

The chart depicts average daily milk production for the three year period as having a value of 1. For each of the three year periods, the chart shows, on a month by month basis, the degree to which that month’s average daily milk production exceeded, or trailed, average daily milk production for the entire year. Thus, if average daily milk production during a given month exceeded the annual average daily milk production by 20%, that month’s production was given a value of 1.20. Conversely, if average daily milk production during a given month trailed the annual average daily milk production by 20%, that month’s production was given a value of 0.80.

What this chart reveals is that seasonality has *sharply* and *steadily* declined over time. For example, during the first time period charted, 1949 through 1951, average daily milk production during the peak month of June was a whopping 27% more than the annual daily average, while average daily milk production during the dip month of December fell almost 20% below the annual average. The line on Chart 1 that depicts production during the 1949 through 1951 time period (the green line) looks like a roller coaster. Handling the milk produced during these sharp peaks and low valleys doubtlessly presented a challenge.

But as Chart 1 clearly reveals, seasonality has sharply, and steadily, declined over time. A comparison of the period from 1949 through 1951 (the green line) to the 1999 through 2001 period (the red line) is particularly revealing. During the earlier period, average daily milk production during the *peak* month exceeded the annual daily average by 27%, but it did so by only 4% during the most recent period. Conversely, during the earlier period, average daily milk production during the *dip* month had trailed the annual daily average by 20%, but it did so by only 4% during the most recent period.

In other words, the swing from peak to dip was 47% of annual average daily production in the period 1949 through 1951, but only 8% in the period 1999 through 2001. Seasonality has thus declined by over 80% over the last 50 years.

While Chart 1 covers national data, the same decline in seasonality can be seen in data relating to the three Northeast order states for which USDA reports monthly data (New York, Pennsylvania and Vermont). Chart 2 tracks seasonality

in those three states, and reveals the same precipitous decline in seasonality as has occurred on a national basis.

In short, if there was ever a need for the type of balancing payment advocated by the proponents, that time came and went long ago.

V. PROPOSAL NO. 7 IS HOPELESSLY FLAWED.

In addition to all of the foregoing, Proposal No. 7 is hopelessly flawed. Small handlers would not qualify for payments regardless of the balancing they perform. Large cooperatives could qualify for payments without providing any marketwide benefits whatsoever. In these respects, the proposal is a direct violation of AMAA requirements.

Moreover, the flow of milk into and out of the order causes producers in the order to pay for balancing services being provided to producers in other orders. This is the very defect that led USDA to reject marketwide service payments the last time they were considered in milk order hearings.

Proposal No. 7 Violates the AMAA. The AMAA specifies the persons who the Secretary must include as recipients of any marketwide service payments. The first group listed is “handlers that are cooperative marketing associations described in paragraph (F), and the second group are “handlers with respect to which adjustments in payments are made under paragraph (C). . . .” Paragraph (C) provides authority for the Secretary to make adjustments in payments by handlers so that each handler’s milk payments are based upon the actual quantity of each class of milk he used multiplied by the prices for each class. Since the

payments by all handlers are adjusted to reflect their actual class usage, all handlers should be eligible for marketwide service payments.

The AMAA makes no distinctions based upon the size of the handler or cooperative. If a small handler or cooperative provides a service of marketwide benefit within the scope of any marketwide service payment program adopted by USDA, that small handler or cooperative is entitled to receive marketwide service payments.

Proposal No. 7 violates these requirements. The Proposal's criteria for receiving marketwide service payments (no more than 65% Class I usage, and pooling more than 1 million pounds of milk a day or 3% of the total milk pooled for the month) would exclude all but the largest handlers. Moreover, IDFA is not aware of any non-cooperative handler that would qualify. Thus, the Proposal violates the statutory requirement that any handler can qualify for the payment.

Proposal No. 7 violates other statutory requirements as well. The principal requirement established for marketwide service payments is that such payments are limited to "services of marketwide benefit." Congress specified three particular services that may be "of marketwide benefit" and therefore may qualify for marketwide service payments. These include providing facilities to furnish additional supplies of milk needed by handlers and to handle and dispose of milk supplies in excess of quantities needed by handlers; handling on specific days quantities of milk that exceed the quantities needed by handlers; and transporting milk from one location to another for the purpose of fulfilling requirements for milk

of a higher use classification or for providing a market outlet for milk of any use classification.

Proposal No. 7 completely fails to meet these AMAA requirements, because the recipients would not be limited to those providing services of marketwide benefit. All that a handler has to do to qualify for such payments is to pool a minimum quantity of milk, and transfer less than 65% of that milk to a Class I plant.

Thus, a person or cooperative that operates a Class III cheese plant, and does so at 100% of plant capacity, 365 days a year, would qualify to receive the 6 cents per hundredweight marketwide service payment. Yet that handler would not have engaged in any activity that meets the AMAA criteria of a service of marketwide benefit.

More generally, the proposal ignores the realities of the market, in that no two Class I plants experience the same need for balancing, at any one time, yet alone across the year. A marketwide service payment of the kind proposed here would charge all producers for costs that are in fact varying and handler specific.

The proposal would cause non-cooperative producers to bear the cost of balancing milk from outside the order. USDA's decision in 1987 to reject proposals for marketwide service payments in the 7 Southeast orders was based in substantial part on the fact that the issue of providing reserve supplies of milk to meet Class I needs is so complex and variable that no one set of regulations can cover the issue without creating significant inequities among market participants.

USDA specifically found that if marketwide service payments had been

established in those orders, those payments would have gone to manufacturing plants that were servicing milk from producers located outside those orders. USDA stated as follows: "With the extensive amount of inter-market milk movements throughout this broad area, the adoption of the proposals would result in producers in the seven markets bearing the burden of balancing milk supplies for handlers not associated with the local markets." Federal Register, Volume 52, Page 15951 (May 1, 1987).

In other words, producers in those Southeastern orders would have experienced a reduction in their pool draws (as a result of the deduction of marketwide service payments) when the only service being provided were to producers in other orders, whose pool draw was left untouched.

The evidence in the Northeast is just as clear, and is, I might mention, not an issue addressed in the Ling study. Appendix 16 of the data that the Market Administrator introduced at the beginning of these hearings tracks by month the quantity of milk that is pooled in the Northeast order from producers located in states outside the boundaries of the order. That data show that milk moves into the Northeast order from those producers in far larger volumes in those months when, according to the Ling study, the most surplus manufacturing capacity is needed.

Specifically, in May, June and July of 2001, more than 100 million pounds of milk a month was received from producers located in states outside the Northeast order boundaries, an amount roughly equal to 5% of the total milk pooled on the order in each of those months. Thus, the manufacturing facilities of the Northeast order are being used to balance the milk supplies in other orders, by providing a

manufacturing outlet in the spring for milk in excess of Class I needs. Yet Proposal No. 7 would call for marketwide service payments to be paid on the milk coming from these other areas, thus causing Northeast producers to cover the cost of maintaining manufacturing plants to balance other markets.

Under these circumstances, Proposal No. 7 would violate the important principle that the milk order system should be as transparent as possible, and that all producers who participate in the pool should be paid uniformly from it. But under Proposal No. 7, some producers will receive only the blend price, while others will receive both the blend price and an extra payment, for services that will be unidentifiable at best and non-existent at worst.

VI. THERE IS NO EMERGENCY.

The Notice of Hearing requests evidence on whether emergency conditions exist that would warrant omission of a recommended decision. Simply stated, there is nothing to suggest that the absence of marketwide service payments is creating an emergency situation that must be addressed by the immediate adoption of a 6 cent per hundredweight payment scheme.

Rather, far from establishing an emergency, the evidence demonstrates that Proposal No. 7 should be rejected.